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Lehman: New Limitations on Plan Payment of Individual Creditors' Committee Members' Professional Fees

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In the recent case of Davis v. Elliot Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 2014 U.S. Dist. LEXIS 48102 (S.D.N.Y. Mar. 31, 2014), the District Court for the Southern District of New York issued a decision barring reorganization plans from paying legal fees of individual members of official creditors' committees absent a showing of substantial contribution to the estate. In so holding, the District Court disapproved a trend among New York bankruptcy courts to permit such payments if they are expressly included in the reorganization plan, notwithstanding a lack of specific authorization in the Bankruptcy Code. As a result of this ruling, indenture trustees that serve on official creditors' committees as part of their role in reorganization cases may find it increasingly difficult to recover their professional fees and expenses pursuant to plan payment provisions.*

I. Committee Members' Legal Fees are not Authorized Administrative Expenses under the Bankruptcy Code

From 1994 to 2005, the Bankruptcy Code permitted legal fees incurred by *ad hoc* committees and individual committee members to be paid as expenses of a chapter 11 case. The enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) (Pub. L. 109–8, 119 Stat. 23, enacted April 20, 2005), however, imposed a limitation on professional fees that could be recovered as administrative expenses.

Section 503(b)(4) of the Bankruptcy Code provides for the reimbursement of certain professional fees "rendered by an attorney or an accountant of an entity whose expense is allowable under" section 503(b)(3)(A)-(E). While expenses incurred by an official committee qualify for reimbursement under this provision, compensation for professional fees of unofficial committees or individual official committee members—including indenture trustees—are not similarly authorized.

Notwithstanding the lack of explicit authorization, a number of bankruptcy courts in the Southern District of New York have confirmed reorganization plans with payment provisions that treat the fees of unofficial committees or individual official committee members as administrative expenses. *See, e.g., In re AMR Corp.,* 497 B.R. 690 (Bankr. S.D.N.Y. 2013); *In re Adelphia Commc'n. Corp.,* 441 B.R. 6 (Bankr. S.D.N.Y. 2010).[1] Reluctant to disrupt a reorganization plan's heavily negotiated terms, courts have found authorization for such provisions in section 1123(b)(6), which permits a plan to include "any . . . appropriate provision not inconsistent with" the Bankruptcy Code. Indenture trustees who served on creditors' committees were thereby able to recover their professional fees through the plan rather than using the payment priority provisions of the indenture, also known as the charging lien.

II. Bankruptcy Court Decision: Fees and Expenses are Recoverable Pursuant Plan Provisions

The *Lehman Bros.* decision was an appeal to the District Court by the U.S. Trustee, after the Bankruptcy Court for the Southern District of New York upheld the rights of members of the official committee of unsecured creditors, including two indenture trustees, to be compensated for legal services rendered by their own attorneys. *In re Lehman Bros. Holdings, Inc.,* 487 B.R. 181 (Bankr. S.D.N.Y. 2013) (Peck, J.). The fees (totaling $26 million) were to be paid pursuant to the consensually confirmed plan of reorganization, subject only to a finding by the court that the fees were reasonable. *Id.* at 192-93; *see also* 1129(a)(4)(subjecting plan payment of costs and expenses to the court's finding of reasonableness). For the committee's two indenture trustees, this permitted recovery of fees and expenses from the estate rather than from plan proceeds distributed to their bondholders.

In his opinion, Judge Peck noted that section 503(b) excludes administrative expense treatment for professional services rendered to members of an official committee, but distinguished such "nonconsensual" payments from "the right to payments made consensually under a plan . . ." *Id.* at 189-91 (internal quotations omitted). Citing the "lopsided affirmative vote by a vast majority of accepting creditors," Judge Peck overruled the U.S. Trustee's objection that such an approach was an improper attempt to circumvent Bankruptcy Code requirements. *Id.* at 193.

III. Decision on Appeal: Lack of Statutory Authorization is Tantamount to Prohibition

In a holding that significantly narrowed the scope of permissible administrative expenses under the Bankruptcy Code, District Judge Sullivan reversed the bankruptcy court's ruling. Interpreting the lack of statutory authority as a prohibition, Judge Sullivan refused to extend administrative priorities beyond those prescribed by the Bankruptcy Code. *Lehman Bros.,* 2014 U.S. Dist. LEXIS 48102, at *20-21.

Relying on the legislative history underlying BAPCPA, Judge Sullivan construed section 503(b)(3)'s omission of professional fee expenses for committee member as a bar to treating such fees as administrative expenses. *Id.* at *12. This interpretation likewise prohibits payments under other plan

[1] The Bankruptcy Court for the District of Delaware has similarly permitted plan payment of individual committee members' fees provided that such fees are approved by the court as reasonable. *See Opinion, In re Wash. Mut.*, No. 08-12229 (Bankr. D. Del. Jan. 7, 2011) [Dkt. No. 6528].

provisions pursuant to section 1123(b)(6) by rendering them "inconsistent with . . . applicable" Bankruptcy Code provisions. *Id.* at *18. Instead, the District Court found Congress' removal of attorney's fees from section 503(b)(4) administrative expense status in 2005 to be dispositive that the Bankruptcy Code now precludes administrative attorney's fee claims based solely on committee member status. *Id.* at *23-24.

Judge Sullivan's opinion does not entirely foreclose the possibility of administrative expense priority for members' professional fees, as these fees may be paid to the extent they qualify as "substantial contributions" under section 503(b)(3). *Id.* at *30-31. Although the Bankruptcy Code does not define "substantial contribution," the bar for creditors seeking recovery of fees and expenses under this provision is high. In the Second Circuit, courts require "extraordinary creditor actions which lead directly to tangible benefits to the creditors, debtor or estate." *In re Alert Holdings,* 157 B.R. 753, 757 (Bankr. S.D.N.Y. 1993); *see also In re Granite Partners, L.P.,* 213 B.R. 440, 446 (Bankr. S.D.N.Y. 1997)("Compensation is limited to those extraordinary actions that foster and enhance, rather than retard or interrupt the progress of reorganization.")(internal quotations omitted).

By conflating administrative expense claims and plan payments, however, the opinion disregards a key distinction: while administrative expense claims pursuant to a court's finding of "substantial contribution" are allowable as of right (and will be paid notwithstanding any objection by parties in interest), plan payments result from a vote of the estate's creditors. Nevertheless, Judge Sullivan's ruling steadfastly asserts that payment of individual committee members' professional fees must be subject to the "substantial contribution" standard, even when such payments are negotiated and agreed-upon by the relevant constituencies. Enforcement of this standard means that payment of indenture trustees' legal fees as administrative expenses could be controversial in future chapter 11 cases in the Southern District of New York.

IV. What this Means for Indenture Trustees and other Committee Members

Judge Sullivan concluded his opinion by remanding the case to the bankruptcy court for a determination of whether the committee members' professional fees qualify as administrative expenses under the "substantial contribution" standard. While a bankruptcy court decision allowing the fees on this basis would afford relief to the *Lehman Bros.* committee members, it would effectively moot any potential appeal and thereby thrust Judge Sullivan's ruling beyond the scope of review.

Unless Judge Sullivan's ruling is reversed by the Second Circuit Court of Appeals, indenture trustees serving on creditors' committees should no longer assume that their individual attorneys' fees will be paid from the general bankruptcy estate as administrative expenses if a provision of the plan so provides and the plan is approved by the requisite creditor majorities.[2] While these fees may be paid under the terms of the indenture, recovery may prove problematic where plan distributions are made in an illiquid (*i.e.,* noncash) form. Indenture trustees may also be faced with the difficult question of whether their fiduciary duty to bondholders (who are themselves reluctant to join creditors' committees) requires them to seek a committee appointment and thereby incur expenses for which they may not be reimbursed.

V. Alternative Grounds for Payment of Indenture Trustees' Professional Fees and Expenses

[2] While Judge Sullivan's ruling is not clearly binding on all bankruptcy courts in the Southern District of New York, *see, e.g., In re Finley*, 160 B.R. 882, 898 (Bankr. S.D.N.Y. 1993) ("A bankruptcy judge . . . is free to reexamine an issue despite the existence of a prior decision of another judge in the same district"), its precedential value cannot be disregarded.

Notwithstanding Judge Sullivan's ruling, indenture trustees may consider several alternative routes to recovering their fees and expenses. For example:

- An indenture trustee of secured bonds may seek an adequate protection order providing for reimbursement of fees and expenses as an adequate protection remedy under section 361.
- Where the indenture trustee has an indemnity claim directly against the issuer (*i.e.,* the debtor) pursuant to the indenture, the claim arguably may be asserted as an administrative expense to the extent that it arises post-petition.[3]
- A plan that distributes noncash consideration to bondholders may provide additional cash to that class of creditors in an amount sufficient to pay the indenture trustee's fees and expenses so as to obviate the trustee's imposition of a charging lien on noncash consideration.
- Incorporating a "substantial contribution" finding into a plan payment provision that is agreed upon by the parties in interest may eliminate grounds for an objection by the U.S. Trustee or make such an objection less likely to succeed.
- Negotiating payment of the indenture trustee's fees and expenses as a settlement under Rule 9019 of the Federal Rules of Bankruptcy Procedure avoids the stringent "substantial contribution" test of section 503(b), as Rule 9019 settlements are subject to court review under the less rigorous "business judgment" standard.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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[3] If the indenture is treated as an executory contract, the debtor's post-petition obligation to perform under its terms extends until the indenture is rejected (which does not generally occur until the plan's confirmation).